

General Information Letter: Petition for alternative apportionment failed to meet its burden of proof to show distortion by the statutory apportionment method or correct apportionment by the proposed alternative.

June 22, 2005

Dear:

This is in response to your letter dated June 14, 2005, in which you request permission, pursuant to Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 101 *et seq.*), for the unitary business group of which COMPANY1 Inc. (FEIN XX-XXXXXXX) is the designated agent to file as two separate unitary business groups. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us. For the reasons discussed below, your petition cannot be granted at this time.

In your letter you have stated the following:

Petitioner contends that its current method of apportionment is unreasonable and that the method taxes extraterritorial values by attributing income to Illinois which is out of all proportion to the business transacted in the state.

Petitioner currently files its Illinois Corporation Income and Replacement Tax Return on a combined unitary water's-edge basis using the statutory single receipts factor (86 Ill. Adm. Code Sec. 100.3390 (IITA Section 304)). Petitioner's operations in Illinois consist of natural gas marketing and chemical manufacturing. Ninety-three percent (93%) of Petitioner's Illinois receipts are generated by the buying and selling of natural gas to supply the Illinois market. The remaining Illinois receipts are from instate and out of state chemical manufacturing operations.

Overall, Petitioner's energy marketing activities which include the marketing of oil, natural gas and electricity, make up seventy percent (70%) of its combined unitary water's-edge gross receipts, and only three percent (3%) of its combined unitary water's-edge taxable income.

The disparity in the percentage of receipts to income generated causes a gross distortion in the amount of income apportioned to Illinois when using a single sales factor, for the entire combined unitary water's-edge group. The purpose of the apportionment formula is to assign profits to Illinois in proportion to the level of business activity a taxpayer conducts in the state. *Continental Illinois Bank v. Lenckos*, 102 Ill. 2d 210, 224 (1984). *Caterpillar Tractor Co. v. Lenckos*, 84 Ill. 2d 102, 123 (1981) (the purpose of the formula is to confine the taxation of income to the portion of the total income that is attributable to local activities). The use of the standard method here is inappropriate because it assigns Petitioner's production and manufacturing income to Illinois by reference to the activity of its energy marketing business.

By combining the Production/Manufacturing operations with the Energy Marketing operations and their disparate receipts factors and taxable income positions, the estimated 2004 Illinois Combined Corporation Income/Replacement Taxable Income is four hundred and six percent (406%) more than if the Production/Manufacturing Operations and the Energy Marketing Operations were apportioned separately.

This is a grossly distorted result. Therefore, in accordance with 86 Ill. Adm. Code Sec. 100.3390 (IITA Section 304(f)), the Petitioner requests permission to use an alternative apportionment method for the tax year ending December 31, 2004, and subsequent years, barring a material change in the facts as presented in this petition concerning the operations or structure of the Petitioner or a pertinent change in the Illinois Statutes.

Section 304(f) of the Illinois Income Tax Act (the IITA, 35 ILCS 5/101 *et seq.*) provides:

If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:

- (1) Separate accounting;
- (2) The exclusion of any one or more factors;
- (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Petitioner proposes a more equitable alternative apportionment method under Section 304(f)(4) above.

Petitioner request to increase the number of combined unitary business groups from two to three. Currently the Petitioner's unitary business groups consist of COMPANY2 and Affiliates COMPANY3 and COMPANY4 and Affiliates COMPANY5.

Petitioner requests to bifurcate its non-pipeline group into two business groups:

- (1) Production and Manufacturing and (2) Energy Marketing.

Petitioner's Production and Manufacturing domestic operations are capital and labor intensive. The Production and Manufacturing Group's operations are principally oil and gas production and chemical manufacturing. Petitioner's Illinois Production and Manufacturing operations consist of one chemical plant with associated inventory, payroll, and sales. Additionally, there are Illinois sales from other chemical plants outside of Illinois, with one salesman supporting that activity. (See Supplemental

Schedule attached for detail of operations in Illinois)

Petitioner's Energy Marketing Operations have very little capital or labor, and consist of very high volume/low margin sales. The Energy Marketing Group currently has no payroll in Illinois, but it can have inventory associated with its energy marketing activity. The Energy Marketing Group includes companies that market oil, gas and electricity. Personnel involved in the marketing function are primarily located in Texas.

As stated, Petitioner's Energy Marketing Group generates seventy percent (70%) of the Petitioner's combined unitary water's-edge receipts. In contrast, the Energy Marketing Group only generates three percent (3%) of the Petitioner's combined unitary water's-edge net taxable income

Petitioner contends that the proposed alternate apportionment method more fairly represents the Petitioner's business activity and income associated with the operations in Illinois. Additionally, the proposed alternate method of apportionment creates a more favorable business climate for the Petitioner's Energy Marketing operations, and would be an incentive to expand its marketing business in Illinois.

The "Supplemental Schedule" referred to in the request includes listings of projected taxable income, total sales, and Illinois sales for members of the unitary business group. The Supplemental Schedule also includes intercompany sales.

Response

Section 304(f) of the IITA provides:

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- (1) Separate accounting;
- (2) The exclusion of any one or more factors;
- (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Taxpayers who wish to use an alternative method of apportionment under this provision are required to file a petition complying with the requirements of 86 Ill. Adm. Code Section 100.3390, which may be found on the Department's web site at www.revenue.state.il.us.

Section 100.3390(c) provides, in part:

The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

The Supplemental Schedule shows that the proposed Production and Manufacturing group had 2004 sales of \$8.5 billion, Illinois sales of \$64.8 million, and taxable income of \$1.9 billion. The Energy Marketing group had 2004 sales of \$19.8 billion, Illinois sales of \$863 million, and taxable income of \$62.3 million.

The Supplemental Schedule also shows that four members of the Production and Manufacturing group had substantial intercompany sales: COMPANY6, Inc., COMPANY7, Inc., COMPANY1, Inc. and COMPANY8. Over 93% of these four corporations' total sales were to COMPANY9, Inc., a member of the Energy Marketing group. These four corporations had over 47% of the proposed Production and Manufacturing group's taxable income and less than 26% of that group's total sales. According to the Supplemental Schedule, none of the intercompany sales is sourced to Illinois, while nearly 5% of the sales of COMPANY9, Inc. are sourced to Illinois.

Placing these four corporations into a group separate from COMPANY9, Inc., would create a high risk of distortion. Setting correct transfer prices for sales between related parties is notoriously difficult problem, and often an impossible one. One of the purposes of unitary or combined reporting is the avoidance of intercompany pricing issues. Moreover, sourcing the sales of these four corporations as if the unitary business group's profits were derived from the intercompany sales rather than by the ultimate resale by COMPANY9, Inc. simply ignores the fact that a unitary business group is operating a single business.

Placing these four corporations in the proposed Energy Marketing group would therefore be more consistent with the principles underlying combined apportionment than placing them in a separate Production and Manufacturing group would be. If these four corporations were placed into the proposed Energy Marketing group, the taxable income of that group would be increased over 1500% with virtually no change in the group's apportionment factor (after eliminating intercompany sales) and the total taxable income apportioned to Illinois by both proposed groups would not be so different from the amount apportioned by combining both groups as to constitute any evidence of distortion.

Accordingly, the petition fails to meet the burden of proof required by regulation Section 100.3390(c) with regard to showing distortion or showing that the proposed alternative fairly represents the group's Illinois business activity.

Please note that 86 Ill. Adm. Code Section 100.3390(e)(1) requires a petition to be filed at least 120

days prior to the due date (including extensions) for the first return for which permission is sought to use the alternative apportionment method. Your petition was filed June 14, 2005, and will allow use of the requested method on original returns due on or after October 12, 2005, if granted.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you still believe that your petition should be granted, please supplement the petition in accordance with the provisions of 86 Ill. Adm. Code Section 100.3390. If you have any questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel -- Income Tax